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It Is Not Over Yet

A new Dodd-Frank Act deadline is approaching

As the calendar turns to July, it is not only the summer heat that is turned up, but the regulatory heat, as well. As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, certain amendments to Section 23A of the Federal Reserve Act, 12 U.S.C. §371c, as well as amendments to other bank regulatory schemes, become effective July 21. If bank management has not already reviewed its policies and made changes to comply with these amendments, the time for the board of directors, compliance officer and compliance committee to do so is now.

As a reminder, Section 23A, together with Section 23B of the Federal Reserve Act, governs transactions between banks and their affiliates (and is further implemented by Regulation W, 12 C.F.R. Part 223).

Sections 23A and 23B establish certain qualitative and quantitative limits for loans, purchases of assets, and certain other covered transactions between a bank and its affiliates, as well as certain other restrictions. For example, a bank may engage in a covered transaction on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, while at the same time, a bank's covered transactions with any single affiliate may not exceed 10 percent of the bank's capital stock and surplus, and transactions with all affiliates may not exceed 20 percent of the bank's capital stock and surplus.

Amended Definition of an Affiliate

Previously, Section 23A defined an affiliate of a bank to include any company that controls the bank; that is controlled by the company that controls the bank; that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the bank or any company that controls the bank; or in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the bank or any company that controls the bank.

The Dodd-Frank Act amends Section 23A to include as an affiliate of a bank an investment fund to which a bank or its affiliate is an investment adviser.

Amended Definition of a Covered Transaction

Prior to the enactment of the Dodd-Frank Act, Section 23A identified each of the following types of transactions as covered transactions: a loan or extension of credit to an affiliate; a purchase of or an investment in securities issued by an affiliate; a purchase of assets from an affiliate, except such purchase of real and personal property as may be specifically exempted by the board by order or regulation; the acceptance of securities issued by an affiliate as collateral security for a loan or extension of credit to any person or company; and the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.

The Dodd-Frank Act amends the definition of a covered transaction to include debt obligations issued by an affiliate as collateral for a loan or extension of credit, and transactions with an affiliate that involves the borrowing or lending of securities, as well as derivative transactions with an affiliate, to the extent any of these transactions cause the bank or its subsidiary to have credit exposure to the affiliate.

Collateral Issues

Section 23A requires that each loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate by a bank or its subsidiary to be secured at the time of the transaction by collateral with a certain market value. The amendments to Section 23A of the Dodd-Frank Act require that each of the above described financial accommodations to or on behalf of an affiliate or its subsidiary be secured at all times by collateral with a certain market value. This will ultimately require the bank to implement a procedure to monitor the market value of the collateral at all times while the transaction is outstanding.

Note, the foregoing requirement that the transaction be secured at all times by collateral with certain market

value now also applies to any credit exposure of a bank or a subsidiary to an affiliate resulting from a securities borrowing, lending transaction or a derivative transaction.


Financial Subsidiaries

The Dodd-Frank Act removes the exception from the quantitative limits for covered transactions between a bank and its financial subsidiary. Under the old rules, covered transactions between a bank and any single financial subsidiary of the bank were exempted from the requirement that a bank's covered transactions with any single affiliate may not exceed 10 percent of the bank's capital stock and surplus. The requirement that transactions with all affiliates may not exceed 20 percent of the bank's capital stock and surplus, however, was still applicable. Now, both quantitative limits apply.

All of the foregoing amendments to Section 23A

will become effective July 21. However, the removal of the exception from the quantitative limits for covered transactions between a bank and its financial subsidiary amendments will apply to any covered transaction between a bank and its subsidiary that is entered into on or after July 21, 2010.

With these changes to Section 23A in mind, and the fact that no amendments have been made yet to Regulation W, it is important for banks to periodically review lending procedures to ensure that bank affiliates deal at arms length in compliance with the requirements of the amended Section 23A. Violations are dealt with seriously by the bank regulators and even the appearance of a violation should be studiously avoided.

Review internal policies with counsel to ensure compliance with these new regulations and educate all officers and directors about the terms of each. 

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